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Energy: Continuing Crisis

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Following is an address by Deane R. Hinton, Assistant Secretary for Economic and Business Affairs, before the Mid-America Committee in Chicago, November 18, 1980.

Generals are said to study warfare and often learn the wrong lessons. Politicians, businessmen, and even bureaucrats may also become adept at winning yesterday's battles, not tomorrow's.

But history still instructs. Being wedded to the past is a mistake, but the past teaches us as well—if only to avoid repeating errors. In this vein, I suggest that lessons from the two oil crises of the 1970s—the 1973–74 embargo and the 1979 interruption of supplies from Iran—if applied to the future, can prevent the current oil supply interruption from seriously damaging our own and the rest of the world's economies.

The current situation is serious, and the longer term crisis continues. We need to act in the short term due to the Iran-Iraq war and in the longer term due to the industrialized world's dependence on imported oil to supply its energy needs. Our efforts to combat these threats must be vigorous and informed by experience, often painfully acquired.

The Right Lessons

Our government, under both Democratic and Republican administrations, has learned the right lessons at times in the past. The 1973 oil embargo and the accompanying cut in production were shocks to the system. Both our economic well-being and our security were put at jeopardy. We analyzed the problem and saw that there were two components—a need to protect ourselves against short-term supply interruptions and a realization that energy price and supply had become a long-term problem requiring ongoing, concerted action in order to avoid continuing vulnerability.

The establishment of the International Energy Agency (IEA) in 1974 was a response to both. This was an instrument to protect us against future embargoes or other major supply interruptions and to help nations work together to reduce our dependence on imported oil through conservation and acceleration of the development of alternative supplies. We realized then that the energy problem had the potential to divide us from our principal economic partners and security allies. Accordingly, we designed the IEA as an energy collective security arrangement. Its centerpiece is an emergency oil-sharing system which can be triggered when needed. The trigger mechanism can be called into operation if the IEA, as a whole, is suffering a shortfall greater than 7%. In addition, any nation suffering a 7% shortfall can activate the system and call upon the other nations to make up continuing additional shortfalls beyond the 7% mark.

This sharing system has a number of strengths. It is capable of being implemented quickly and makes use of a previously agreed mechanism and formula. Triggering the system would give the United States and other IEA governments legal authority to implement strong domestic measures if necessary. Also, sharing would make oil available to hard-hit IEA countries and to oil-short companies in such countries, reducing the

tendency to resort to the spot market where small quantities of petroleum products and crude oil are traded to clear the market, which is overwhelmingly dominated by long-term contracts. Price rises in the thin spot market create a psychology which encourages hikes in official prices—which consequently boost the overall oil bill.

The long-term lesson from 1973 was that the era of cheap and accessible energy had passed and that a continuing energy crisis was in train. Recognizing this, we embarked upon a vital journey, which is far from finished—a journey designed to improve our national approach to energy and to stimulate other countries to do the same. We have made much progress. At home, we are reducing our dependence on imported oil. For example, U.S. oil imports were below 7 million b/d [barrels per day] in the first 6 months of 1980 compared to 8.6 million b/d in 1977. In addition, increased energy efficiency has enabled us partially to decouple GNP growth from growth in oil consumption so our economy can expand without increasing our dependence on imports.

I won't review here the evolution and the vicissitudes of our national energy policy, but I think it can honestly be said that we have more than begun on the long road toward increasing our energy supplies and making better use of what we have. While we must concentrate first on putting our own house in order, we also must continue to cooperate actively in pursuit of these same goals with our allies in the IEA and at the annual economic summits of the industrial democracies.

The Second Crisis

After the shocks of 1973 and 1974, we were making headway throughout the mid- and late-1970s. IEA efforts and our national policies were moving in the same, positive direction, although we were slower in starting than our IEA counterparts.

Unfortunately, in 1979, Iranian supplies were interrupted, and we were taught another lesson. This was a clear example of vulnerability to attack from an unexpected direction. The IEA system was designed to meet a recurrence of the 1973 experience—a major shortfall (above 7%) or an embargo. But history did not repeat itself. The interruption in 1979 was considerably less than 7%. We did not have an IEA mechanism on the shelf to deal with it.

We soon learned a painful lesson that even a small interruption, under conditions of uncertainty, could have devastating economic consequences. Although the decline in Iranian production was only 4% of world production, market dislocations and price increases buffeted a world economy which had still not fully recovered from the 1973 oil price shock. These blows helped push the United States into recession and slowed economic growth in the other industrial nations. In the United States our total inflation grew to double digits. For the industrialized nations as a whole, it is estimated that the price hikes of 1979 will ultimately cause a loss of about $300 billion in GNP. And the fragile economies of the developing nations have been scarred even more severely by these higher oil prices.

The IEA developed a response to the 1979 crisis. Its members made a commitment—albeit a loose one—to reduce the group's demand for imported oil by 2 million b/d. Each nation's share of the reduction, as well as the time within which action had to be taken, was unspecified. Although significant savings of about 1.5 million b/d, or 6% of 1978 IEA imports, were achieved by the end of 1979, this was too late to forestall sharp price increases. IEA governments, focusing on the modest quantity of the shortfall, had underestimated the psychological impact of the crisis on the market. Midway through the year the United States came to the conclusion that the IEA response to the 1979 crisis was inadequate.

Another Lesson: The Need for Better Tools

The United States, therefore, took the lead in giving the IEA and the world community better tools to meet a shortfall. The most important of these is national ceilings on oil imports. At the Tokyo summit in June 1979, the seven largest industrial democracies adopted 1985 oil-import targets. The IEA subsequently refined and expanded these into national import ceilings for 1980 and national import goals for 1985 for all its members. This process has been institutionalized by the establishment of a system within the IEA in which ceilings would be imposed to counteract a market shortfall. Each nation would be responsible for determining the measures necessary to achieve its ceiling.

Thus, we are not without resources to face supply interruptions. In fact, our experience in the IEA has expanded our options beyond those which I have discussed. And we have established practices of consultation and cooperation which will permit us to tailor our responses directly to any concrete situation.

Dimensions of the Present Situation

In this way, we have refined, through chastening experience, our abilities to deal with oil-supply interruptions. Now we are faced with another novel and threatening situation—the Iran-Iraq war. The energy effects of war between the two oil producers are serious, although they have been manageable thus far. The war has taken 3.8 million b/d of oil exports off the world market, over 8% of oil produced in non-Communist countries. Since world consumption has declined, we can simply do without some of this oil—about 1 million b/d of it. Another 1–1.5 million b/d can be made up through increased production from the Saudis and other OPEC [Organization of Petroleum Exporting Countries] nations. This leaves a shortfall of over 1 million b/d, which is now being met by drawdowns of above normal stocks in some nations and by some belt tightening in nations without adequate stocks.

The extent of any possible continuing shortfall will depend on a number of factors, including how much additional supply is made available by other OPEC nations, whether companies and individuals begin to hoard oil supplies and whether the war expands to other nations or interferes with gulf shipping.

Since world stocks are at an all-time high, we should, in principle, be able to manage the current shortfall for at least the next 6 months. However, there are complicating factors. The current shortfall is not distributed evenly among countries and companies. The United States lost a very small percentage of its oil. Some IEA members—Italy and Japan—lost 15% and 8% respectively, while others—Turkey and Portugal—were hit more severely. France lost 30%, and Brazil and India have been cut by more than 40% each. In addition, many developing nations depended on Iraq for most of their oil and received it at much needed concessional terms.

Even in countries which have lost little overall, certain companies have suffered substantial losses. This means that even though world stocks are high, some nations and companies are hurting now, and others will be in the near future. If they are unable to secure adequate supplies elsewhere, they may turn to the spot market to make up their shortfall.

If they do so, spot market prices will increase, perhaps rapidly. OPEC ministers who meet in Bali on December 15 will be very attentive to price trends on the spot market. If history repeats itself, official price increases would follow and be reflected in long-term contracts for

1981 which will be negotiated next month. Some producers, in response to rising spot prices, may also impose surcharges on their official prices. Because of this price effect of a shortfall, all buyers would suffer. Even countries which lost few supplies—such as the United States—would bear a heavy burden.

In trying to plot our course of action during the next months, we must begin with a premise: It is unacceptable to permit oil prices to skyrocket as they did in 1979. Several key elements in the 1979 price escalator must be attacked—the leading role of spot prices, excess stock building, and fear of uncertainty in oil markets. If we focus on these factors and have learned our lessons well, we can defend ourselves adequately against another body blow to the world's economy.

Peace Efforts and IEA Cooperation

The first step is to reduce war-linked uncertainty in the oil market by encouraging those forces working for peace between Iraq and Iran.

- We are actively working through the U.N. Security Council toward a resolution of the conflict which does justice to the legitimate concerns on both sides and follows the principles of international law.
- The U.S. position from the beginning of this conflict has been clear. We are impartial but not uninterested. The political, economic, and human consequences of a continuing conflict are of vital importance to us and the rest of the world.
- We are concerned that the conflict not be expanded and have taken steps to prevent that. We believe, strongly, that there must be no infringement of the internationally recognized freedom and safety of navigation in the Persian Gulf and welcome assurances given by both Iran and Iraq in this regard.
- We believe, as well, that countries should be protected against interference in their internal affairs and that international disputes should be settled by peaceful means rather than by force.

Beyond peace efforts, our principal aim is to keep the world supplied with oil in a way that reduces pressure on oil prices. On the supply side, certain gulf countries such as Saudi Arabia, Kuwait, and the UAE [United Arab Emirates] have increased production to try to make up some of the shortfall suffered by customers of Iraq. Exports may also increase from nations such as Nigeria, which were producing at less than normal levels due to slack demand. The most we can hope for from these countries is an extra 1–2 million b/d, with the lower end of the range more likely.

On the demand side, we are cooperating with the 20 other industrialized nations who are members of the IEA and with France to calm the market. There are two related aspects to this effort. First, we can ease spot market pressure by using existing stocks. Second, we have to reduce overall demand for imported oil to compensate for reduced supply.

IEA nations agreed on October 1 to avoid abnormal purchases on the spot market and to meet any shortfall through stock draws. This has had a useful effect thus far. The IEA policy is based on consultation and persuasion, and we are depending in the last instance on the cooperation of oil companies. We must recognize that companies may become reluctant to draw down stocks even at normal rates if they foresee a continuing shortfall. If this proves to be the case, the buffer of high stocks, lacking in 1979, but which has furnished a cushion for us in 1980, will comfort us less and less in the future.

What we do further depends on our and the market's continuing assessment of prospects for resumption of something approaching normal levels of production from Iraq and Iran. This requires judgments about the length of the war and the likely pace at which their exports could be restored to more normal levels. Based on the limited information available, damage to oil production and export facilities in both countries, to date, is not excessive, and exports will be likely to rise, to some extent, soon after hostilities cease. It may be some months, however, before exports would approach prewar levels. Any new or, as yet, unreported damage to oil facilities could extend this period, as would any difficulties in organizing repair efforts.

What Should Be Done Now?

While we cannot foresee the outcome of the conflict, we can act to mitigate its effect. We will be continuing discussions with our friends and allies in the next few weeks and will concert our responses to the oil markets in light of the situation in the Middle East. The adoption of import ceilings, activation of the sharing system, or other responses could require strong domestic measures. To handle short-term emergencies, nations have proposed measures such as fuel switching, emergency taxes or tariffs, temperature control standards, leaving cars home one day a week, and others. In 1979, we relied on fuel switching, temperature controls, and increasing production, where possible. We might need some additional mechanisms in 1981.

Whether any of these actions is ever used, the point remains: In order to reduce short-term price pressure, we need to reduce demand for oil. The choice is quite simple. We can cut back a bit now or risk paying the price. In this case, the price could be \$30–\$90 billion additional per year for our oil, resulting in reduction of growth, higher inflation, and diminution of our strength and international position. This was the real choice facing IEA countries in 1979, though we did not know it at the time.

Better Mechanisms and Expanded Supplies

We still need to learn, for the next time. The public needs to understand that the energy problem is not going to go away. We need to act consciously to manage it. We need to have popularly supported mechanisms to minimize upward price pressure during short-term interruptions and, for the longer term, to reduce more rapidly the dependence of the United States and other nations on imported oil and speed the transition to other energy sources. We need to spur production.

Some of these mechanisms we can adopt ourselves; others require cooperation from other industrialized nations as well as the producing nations. Short-term demand restraint possibilities have already been mentioned. Longer term measures to increase available supply include increasing production from domestic energy resources—coal, oil, gas, and nuclear; hastening the development and commercialization of new energy technologies—solar, biomass, shale oil, liquids, and gas from coal; emphasizing conservation and efficiency; and expanding cogeneration of heat and power.

Considerable effort should be devoted to expanding secure energy supplies. We are taking the lead ourselves in coal. We are in the early stages of a substantial long-term coal export strategy by which we will increase our economic strength and also help our energy-deficient trading partners by providing them with reliable long-term energy supplies.

Other nations with abundant energy resources should respond to the needs of their friends and the world economy. Under foreseeable circumstances, it pays no nation to limit energy production for short-term national interests. This prescription applies across the board, since the political and economic security of every nation would be threatened by a chaotic and crippled energy-short world economy.

In our relations with key OPEC nations, we have emphasized their stake in a sound world economy and the importance of adequate, reasonably priced oil supplies to world economic health. Some nations, particularly those of the Arabian Peninsula, see the merits of a long-term perspective and are producing at levels far above those required for their domestic economies.

But the industrialized nations cannot ask OPEC to produce energy to respond to the needs of the world economy if they, themselves, will not. In this regard, Canada's recent announcement of a new national energy policy, which appears likely to result in limiting Canadian production, seems to be out of step with the rest of the world. We hope that, as details of Canada's new program are worked out, the Canadian Government will recognize its more general responsibilities to create incentives—including price increases—rather than disincentives to energy production. We also hope that nations such as the United Kingdom and Norway will produce at maximum efficiency in order to provide more secure sources of energy supply.

We are doing our part. Energy policies now in place are having an appreciable effect on our energy balance sheet. We have reduced our oil imports by 25% since the peak year of 1977, and we are well on the road to increased energy production. We can now exercise greater leadership, internationally, in confronting the world's energy problems since we have turned from a nation with one of the weakest energy programs into a nation with one of the strongest. Policies and legislation have been effective in reducing demand and increasing supply, especially through gradual oil and gas price decontrol, incentives for greater energy efficiency in homes and businesses, fuel efficiency standards, building temperature controls, the Synfuels program, and related measures.

But we cannot rest on our laurels. We have a long way yet to go. The war between Iraq and Iran is a telling reminder that the unpredictable and irrational does occur. We must strengthen our ability to react even to extreme cases. Ultimately, we will have learned the right lessons when the American people understand that our well-being and security are at stake in our response to the continuing energy crisis. ■

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